BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

FILED
05-31-07
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In the Matter of the Application of SAN GABRIEL VALLEY WATER COMPANY (U337W) for Authority to Increase Rates Charged for Water Service in its Fontana Water Company Division by $5,662,900 or 13.1% in July 2006; $3,072,500 or 6.3% in July 2007; and by $2,196,000 or 4.2% in July 2008.	)	Application 05-08-021 (Filed August 5, 2005)
Order Instituting Investigation on the Commission's Own Motion into the Rates, Operations, Practices, Service, and Facilities of San Gabriel Valley Water Company (Utilities 337 W).	)	Investigation 06-03-001 (Filed March 2, 2006)

RESPONSE OF SAN GABRIEL VALLEY WATER COMPANY TO CITY OF FONTANA, ET AL. APPLICATION FOR REHEARING AND RECONSIDERATION OF DECISION 07-04-046

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Pursuant to Section 1731(b) of the Public Utilities Code and Rule 16.1(d) of the Commission's Rules of Practice and Procedure, San Gabriel Valley Water Company ("San Gabriel," the "Company," or "SGV"), Applicant and Respondent in the above-captioned proceedings, hereby respectfully responds to the "Application for Rehearing and Reconsideration" of Decision ("D.") 07-04-046 that was submitted for filing on or about May 15, 2007, by the Division of Ratepayer Advocates ("DRA") and intervenors City of Fontana ("City") and Fontana Unified School District ("FUSD") (collectively, "Intervenors/DRA"). San Gabriel's response is timely filed.[1]

[1] San Gabriel itself filed an application for rehearing of D.07-04-046 on May 16, 2007. In accordance with Rule 16.1(d), all responses to an application for rehearing of a particular decision are due within 15 days after the date on which the last application for rehearing of that decision was filed. Thus, San Gabriel's response to Intervenors/DRA's application for rehearing of D.07-04-046 is due 15 days after May 16, *i.e.*, by May 31, 2007.

I.

SUMMARY OF INTERVENORS/DRA'S CLAIMS AND SAN GABRIEL'S RESPONSE TO THOSE CLAIMS

Intervenors/DRA present four claims of error in D.07-04-046 (the "Decision"). First, they claim to see a violation of Public Utilities Code Section 1705 and a "fundamental denial of due process" in the alleged failure of the Decision to address "the issue of 2002-post project review." Intervenors/DRA Application for Rehearing and Reconsideration ("App./Rhg."), at 1. Second, they assert that the Decision's exemption of San Gabriel's investment of up to $35 million in the Sandhill Surface Water Treatment Plant ("Sandhill") project from the adopted rate base cap and its allowance of "advice letter treatment" for such investment are arbitrary and capricious and not supported by substantial evidence. App./Rhg., at 2. Third, they contend that the Decision's findings that San Gabriel's record-keeping for "contamination, condemnation, and purported Public Utilities Code Section 790 monies" was proper "cannot be reconciled with the evidentiary record or with the decision itself." App./Rhg., at 2. Finally, they challenge the Decision's deferral to Phase II of the gain on sale rulemaking, R.04-09-003, of ratemaking treatment for some $2.3 million San Gabriel received with respect to "service duplication inverse condemnation claims." App./Rhg., at 2.

The claims stated by Intervenors/DRA have no merit whatsoever. They amount to nothing more than restatements of arguments presented by the City, DRA, the FUSD, or some combination of those parties at previous stages of this proceeding – arguments that the Commission already has rejected in the course of arriving at the Decision or a prior decision. Intervenors/DRA present what might be considered claims of legal error only with respect to the first three of the four issues noted above. Apparently, the lack of any notion of a legal basis for the fourth claim is the reason why Intervenors/DRA styled its pleading as an "Application for Rehearing and Reconsideration," a form of pleading not previously accepted by the

Commission's Docket Office. San Gabriel's response will treat Intervenors/DRA's filing as an application for rehearing and hereafter will refer to it as such.

II.

THIS GRC AFFORDED PARTIES AMPLE OPPORTUNITY TO CONTEST ANY OF SAN GABRIEL'S POST-2002 PROJECTS AND THEIR FAILURE TO DO SO PRESENTS NO BASIS TO CHALLENGE THE DECISION.

Intervenors/DRA filed an application for rehearing of D.04-07-034, the principal decision in the prior general rate case ("GRC") for San Gabriel's Fontana Water Company division ("Fontana Water Company") and that application for rehearing was granted by D.05-08-041, dated August 25, 2005. Eventually, by D.06-06-036, the Commission revisited the issues on which it had granted rehearing, affirming D.04-07-034 and concluding that the earlier decision had resolved those issues correctly. In the meantime, pursuant to the Rate Case Plan for Class A Water Utilities, San Gabriel filed the present GRC in August 2005, Intervenors/DRA submitted testimony in November 2005, evidentiary hearings were held and concluded in January 2006, and briefs were filed in February and March 2006, but a decision on the merits of the present GRC did not issue until D.07-04-046 was adopted in April 2007. Based on the temporal overlap between the rehearing of D.04-07-034 and the pendency of this GRC, Intervenors/DRA now seek to concoct a claim that the Decision in this case failed to provide "the promised review of projects constructed under the previously approved rate base cap." App./Rhg., at 3. This claim is completely without merit.

Intervenors/DRA complain that prior to the commencement of evidentiary hearings in this GRC in January 2006, "no direction was given . . . that there should be a focused review on projects that had been constructed pursuant to the rate base cap" authorized in the prior GRC by D.04-07-034. App./Rhg., at 4. No such direction need have been given, since the review of

projects constructed and included in the recorded plant in service that provides the basis for forecasting test year rate base always are subject to review in a GRC.

Intervenors/DRA apparently became concerned that they had missed an opportunity to criticize San Gabriel's construction projects completed since the 2002 base year of the prior GRC when they noted the following statement in ALJ Barnett's proposed decision on the rehearing issues, released for comment in May 2006:

> "The construction budget, and rate base, will get a third review in the current GRC, A.05-08-021. In that third review, we will have the opportunity to determine the reasonableness of what actually has been constructed since 2002. To the extent that construction was unneeded it will be found to be unjustified and therefore unreasonable. . . . This is the lesson of all rate cases which are based on a forecast year."

As Intervenors/DRA have recounted at pages 4-6 of their current application for rehearing, the City responded to this statement in the ALJ's proposed decision by asserting, among other claims, that "none of the parties . . . was on notice that projects constructed pursuant to the rate base cap were subject to this review in the current rate case proceeding [and so] did not address whether projects constructed since 2002 were justified." City's Comments on ALJ Barnett's Proposed Decision, dated June 5, 2006, at 3-4, *quoted in* App./Rhg., at 5. DRA responded along the same lines, claiming to have been "unaware" that a review of post-2002 projects covered under the 10% rate base cap would be included in the current GRC, and that the "parties did not present evidence in this proceeding regarding these post-2002 projects." DRA Comments on ALJ Barnett's Proposed Decision, dated June 5, 2006, at 3-4.

San Gabriel responded to these contentions by the City and DRA in reply comments filed June 12, 2006, as follows:

> "Either the City and DRA are intentionally seeking to mislead the Commission, or they have failed to do even the barest due diligence in preparing their arguments. In the current GRC, San Gabriel presented evidence regarding the 'post-2002 projects' in which it invested and which

> it included in Utility Plant in Service for recorded years 2003 and 2004 and estimated year 2005. *See*, Exhibit 1 (LoGuidice/SGV), Tables 8A and 8B. The Master Data Request requires DRA to tour the utility's system, including 'plant that has been installed and constructed since the last [GRC].' DRA conducted such a tour and reviewed San Gabriel's evidence, comparing budgeted and actual plant additions over at least the last six years. *See*, Exhibit 45 (Schultz/DRA), at 8-1 to 8-3. DRA's claims to the contrary at this late date are simply false.
>
> "Most importantly, all parties had ample notice that inclusion in rate base of projects built under the rate base cap would be subject to challenge in the current GRC. In addressing the proposed rate base cap in its reply brief in A.02-11-044, San Gabriel explained that when the Commission forecasts plant additions for calculating rates, this does not bar parties in a later GRC from challenging the inclusion of actual investments in rate base, and that the same rule should apply if the Commission sets a cap on plant additions instead of approving particular projects. Applicant's Reply Brief, filed December 12, 2003, in A.02-11-044, at 35-36; *see also*, Applicant's Supplemental Brief, filed January 16, 2004, in A.02-11-044, at 2 (noting that both San Gabriel's and DRA's cost of capital witnesses recognized that such 'after-the-fact' review presented a significant regulatory risk).
>
> "The Commission made the same point in D.04-07-034 – the very decision that is now subject to rehearing:
>
> > 'When the Commission approves a projection of plant additions in setting rates, there is a presumption that the utility's investment in the planned capital projects is reasonable. However, this does not bar staff from challenging the inclusion of such investments in rate base in a subsequent proceeding, once the investments have been made. The same rule should apply if the Commission sets a cap on rate base additions instead of approving a specific set of projects.'
>
> *"Id.* at 13-14. The City's and DRA's current protests of ignorance about this standard procedure for rate case review should be given no credence or weight by the Commission."

San Gabriel Reply Comments on ALJ Barnett's Proposed Decision, dated June 12, 2006, at 3-4. The Commission's adoption of the above-quoted portion of ALJ Barnett's May 2006 proposed decision without change in D.06-06-036 evidences the Commission's rejection of the City's and DRA's argument that they lacked "notice" of the opportunity to review the reasonableness of San Gabriel's post-2002 plant investments in the current GRC. *See*, D.06-06-036, at 9.

San Gabriel has quoted its reply comments from June 2006 at such length because they remain highly pertinent to the argument Intervenors/DRA are repeating in their present application for rehearing. Neither the City nor DRA ever responded to the facts San Gabriel presented in those reply comments, but instead simply persisted in the same disingenuous argument about "lack of notice" that the Commission had rejected in D.06-06-036. Thus, in comments filed in February 2007 on the proposed decision and the alternate proposed decision that led to D.07-04-046, DRA harked back to D.06-06-036 as having "clearly stated that the current GRC here, A.05-08-021, would provide an opportunity to review the reasonableness of what San Gabriel constructed since 2002," but contended that the parties "did not receive the opportunity to address these issues." DRA Comments on Alternate Proposed Decision of Commissioner Bohn, filed February 26, 2007, at 13-14; DRA Comments on Proposed Decision of ALJ Barnett, filed February 26, 2007, at 7; *see also*, City Comments on Proposed Decision of ALJ Barnett, filed February 26, 2007, at 5-6.

Intervenors/DRA now present their "lack of notice" argument for a third time, but it is no more valid now than it was in June 2006 or in February of this year. As San Gabriel responded in reply comments on the alternate proposed decision ("APD"),

> "At this late date, DRA wants to reopen evidentiary hearings to review the reasonableness of utility plant San Gabriel constructed since 2002. DRA claims to have learned that this GRC provided a forum for such review only when that point was noted in D.06-06-036, on rehearing of issues initially resolved in D.04-07-034. DRA Comments on PD, at 13. However, DRA's decision to devote little attention to this issue does not, by any stretch of imagination, support its claim that the parties had no opportunity to do so.
>
> "DRA points to the Scoping Memo in this proceeding as not having specified that projects constructed since 2002 would be subject to review. DRA Comments on PD, at 13. The Scoping Memo did not need to do so. It goes without saying that potential issues in any GRC include the reasonableness of the utility's investments in plant since the last recorded year considered in the prior GRC. The fact that DRA and its consultants

> did not devote more attention to this issue supports the conclusion that they did not see sufficient grounds to challenge the Company's past investments. [Footnote omitted.] There is no good cause for reopening the evidentiary record at this late date – and certainly no deficiency in the APD that warrants doing so."

San Gabriel Reply Comments on Alternate Proposed Decision of Commissioner Bohn, filed March 7, 2007, at 4-5.

Exhibit SG-1 to San Gabriel's application, which was submitted in August 2005 and received into evidence in this GRC in January 2006 as Exhibit 1, was titled Fontana Water Company Division Report on Operations and prominently referred to "Recorded Years 2000-2004" as well as subsequent estimated, test, and escalation years. *See*, Exhibit 1 (Batt,Dell'Osa,LoGuidice/SGV), cover page. Chapter 3 of Exhibit 1 addressed "Present Operations" of Fontana Water Company, including the following explicit summary of recent plant additions:

> "Since the last general rate case, the company has started or completed major plant additions including the Sandhill Surface Water Treatment Plant modification, construction of three water storage reservoirs and four booster pumping stations, the drilling and equipping of two water production wells, construction of one ion exchange water treatment facility, and the installation of more than 465,000 lineal feet of water transmission and distribution pipelines."

Exhibit 1 (LoGuidice/SGV), at 3-2. All these plant additions were "fair game" for DRA, the City, and the School District to investigate, evaluate, and challenge in the present GRC.

The City and DRA ***did***, in fact, challenge some of San Gabriel's post-2002 utility plant additions – *e.g.*, the ongoing upgrades at Sandhill and the Company's acquisition of a site for the new headquarters complex. And they did so without any special notice or invitation in the Scoping Memo, because ***they knew*** that this GRC was the appropriate forum for mounting that challenge. Indeed, if they harbored any doubts about whether to challenge

other post-2002 plant additions, they never said so until long after the evidentiary phase of this GRC had been completed and the evidentiary record had been closed.

III.

THE DETERMINATION TO ALLOW SANDHILL INVESTMENTS IN RATE BASE BY ADVICE LETTER NOT SUBJECT TO THE RATE BASE CAP WAS WELL-REASONED AND BASED ON SUBSTANTIAL EVIDENCE.

The next contention of Intervenors/DRA is that exempting Sandhill investments from the rate base cap and allowing advice letter treatment for such investments is arbitrary and capricious and not supported by substantial evidence. App./Rhg., at 8. This is another bogus argument.

As Intervenors/DRA concede, the Decision "discusses the Sandhill project in great detail, . . . finds that the Sandhill project upgrade is justified, caps its costs to $35,000,000, subjects the costs to future reasonableness review, and clarifies that the facilities fees generated by new development will be applied to help take Sandhill out of ratebase," while also addressing other arguments raised by Intervenors/DRA. App./Rhg., at 8. Despite all these indications of a thorough, even-handed review, Intervenors/DRA insist that exempting Sandhill from the rate base cap and allowing it to be phased into rate base by advice letters are "fatally flawed." *Id.*

According to Intervenors/DRA, it is "arbitrary" to create an exception to a rate base cap of the magnitude required for Sandhill, particularly because the project "has so little going for it." *Id.* To support these assertions, Intervenors/DRA merely recycle their arguments opposing the Sandhill upgrade project that were presented on brief and in comments on the proposed and alternate proposed decisions. *See*, App./Rhg., at 9-13. San Gabriel rebutted these factual and rhetorical arguments in its reply brief and in reply comments on the alternate proposed decision, noting that substantial evidence in the record identifies the project's primary

function "as an economical source of base-load water production" well supported by Mr. Dell'Osa's cost/benefit analysis and explaining that recognition of the need for Sandhill justifies exemption from the rate base cap for the large investment required. San Gabriel Reply Brief, filed April 14, 2006, at 18-19; San Gabriel Reply Comments on Alternate Proposed Decision of Commissioner Bohn, filed March 7, 2007, at 3. The Decision itself fully explains the great value of the Sandhill upgrade project, based primarily on evidence showing the low cost of water production through the planned facility, and further explains the need for exemption from the rate base cap to allow this "large single investment" to go into rate base over multiple years. D.07-04-046, at 38-41.

Intervenors/DRA further allege that coupling the rate cap exemption with advice letter treatment is "arbitrary in itself," because "advice letter treatment is inappropriate for large controversial projects" and should be used only "for ministerial rather than controversial matters," and because San Gabriel's conduct on unrelated issues "demonstrates it deserves heightened – not reduced – scrutiny." The unsupported *ad hominem* attack on San Gabriel's trustworthiness certainly deserves no weight as a legal argument. And the critique of applying advice letter treatment to a "large controversial project" misses the point that the advice letter review to be conducted by Water Division will not concern the merits of the Sandhill project – on which the Commission already has ruled – but rather will concern the verification of investments made and accounting records adjusted accordingly. This will be precisely the sort of ministerial review the Commission previously has authorized to be conducted by advice letter in regard to a comparable surface water treatment plant in California Water Service's Bakersfield district. *See, Re California Water Service Co.* (2001), D. 01-08-039; *see also*, San Gabriel Reply Comments on Alternate Proposed Decision of Commissioner Bohn, filed March 7, 2007, at 2-3.

Intervenors/DRA have shown no legal error in the Decision's careful review and approval of the Sandhill upgrade project. They have identified no error in the rationale for the project or in the relevant cost/benefit analysis, nor have they shown any flaw in the Decision's reasoning that led the Commission to exempt the Sandhill project from the rate base cap or to allow the use of advice letters to achieve timely inclusion of Sandhill investments in rate base – to the extent those investments are not matched by Facilities Fees collected from developers and new customers. The allegation of "arbitrary" decision making is simply without merit.

IV.

THE FINDINGS THAT SAN GABRIEL'S RECORDS OF RECEIPT AND INVESTMENT OF SALES, CONTAMINATION, AND CONDEMNATION PROCEEDS WERE DETAILED AND ADEQUATE WERE WELL-REASONED AND BASED ON SUBSTANTIAL EVIDENCE.

Intervenors/DRA are unhappy with the Decision's findings that "San Gabriel has maintained detailed records necessary to document its investment in utility plant of the net proceeds of property sales, contamination, recovery, and involuntary conversion" and that "[the] records San Gabriel kept were adequate to show the receipt of funds and the expenditure of funds." *See*, App./Rhg. at 15, disputing Findings of Fact 80 and 82 (Decision, at 125). Intervenors/DRA contend that these findings are not supported by the record and dislikes the Commission "putting its stamp of approval on improper record keeping." App./Rhg., at 15-16.

Intervenors/DRA perceive an inconsistency between these findings and the Decision's assertion that San Gabriel must have used "gain proceeds" to pay dividends and a further inconsistency in San Gabriel's testimony as to the amount of gains from real property sales. *Id.* at 16-17. Intervenors/DRA also criticize San Gabriel's records tracing reinvestment of "Section 790 proceeds" as "after-the-fact" accounting and attack San Gabriel witness

Nicholson's use of a "standard form memo" that labeled San Gabriel's purchase of real estate from an affiliate as a "Section 790 transaction." *Id.* at 17-18. All these contentions are wrong.

A. The Tension Between the Records Findings and the Assertion That Gain Proceeds Must Have Been Used to Pay Dividends Can Best Be Resolved by Correcting the Latter Assertion, Which Is False and Contrary to the Record.

Intervenors/DRA see Findings 80 and 82 as inconsistent with the Decision's assertion, at page 92, that San Gabriel must have used "gain proceeds" to pay dividends. But the findings are soundly based in the evidentiary record, while the discussion of the relationship between "gain proceeds" and dividend payments – both in the staff Audit Report and in the text (but not the findings) of the Decision – is confused and incorrect.

In its comments on both the ALJ's proposed decision and Commissioner Bohn's APD, San Gabriel challenged the assertion that "San Gabriel could only pay $40.9 million in dividends by using the gain proceeds as if they were San Gabriel's exclusively." San Gabriel pointed to clear and undisputed evidence[2] that the Company's Trust Indenture "restricts the payment of dividends to accumulated net earnings from operations only, and that it was only from such operating earnings that dividends were paid." San Gabriel's Comments on APD, at 3. San Gabriel noted that the staff Audit Report failed to recognize this contractual limit on the Company's payment of dividends, and artificially reordered the Company's cash flows to make it appear that dividends only could be paid from proceeds of property sales. *Id.*, referencing Exhibit 63 (Loo/DRA); *see also*, San Gabriel Opening Brief, at 173-77; San Gabriel Reply Brief, at 33-35.

[2] Exhibit 14 (Batt/SGV), at 6-8 and Att. E; Exhibit 29 (Whitehead/SGV), at 2; Tr. 601:20-602:5 (Batt/SGV); *see also,* Exhibit 16 (Snow/SGV), at 5-10; Exhibit 28 (Batt/SGV), at 4. Consistently, Mr. Snow, San Gabriel's expert accounting witness, testified that dividends are paid from "the net profits of the organization." Exhibit 28 (Snow/SGV), at 1, 3.

San Gabriel used the "gain proceeds" as its "primary source of capital" for infrastructure investments (as expressly required by Section 790), but also pointed out that it could have "sequestered" all the "gain proceeds" in a bank account instead of investing them in new plant and could have raised funds elsewhere for such investments, without ever having to reduce dividends to shareholders. Thus, there is no rational basis for the assertion that "San Gabriel could only pay $40.9 million in dividends by using the gain proceeds as if they were San Gabriel's exclusively." San Gabriel Comments on APD, at 3-4.

The Commission responded to San Gabriel's comments by deleting the phrase, "as if they were San Gabriel's exclusively," from the assertion of a connection between "gain proceeds" and dividend payments. This did not cure the problem. The fact is, as the evidence just referenced establishes, that San Gabriel was contractually obliged by its Trust Indenture to pay dividends ***only from unrestricted net earnings from operations***, which expressly excludes gains from transactions such as sales of property, condemnations, and contamination settlements." Thus, there is simply no connection between the "gain proceeds" and San Gabriel's payment of dividends.[3]

B. Intervenors/DRA's Other Grounds for Criticizing the Records Findings Are Invalid.

The other grounds for Intervenors/DRA's criticism of Findings 80 and 82 are completely without merit. Intervenors/DRA claim to see inconsistency in San Gabriel's testimony as to the amount of gains from real property sales, criticize San Gabriel's records tracing reinvestment of "Section 790 proceeds" as "after-the-fact" accounting, and attack San Gabriel witness Nicholson's use of a "standard form memo" that labeled San Gabriel's

[3] In line with San Gabriel's APD comments, the accuracy of the Decision would be enhanced by revising the first sentence of the last paragraph on page 92 to read as follows: "We disagree with DRA that San Gabriel could only pay $40.9 million in dividends by using the gain proceeds, because even had such proceeds been sequestered in a special bank account San Gabriel could have continued paying dividends from operating earnings while funding its plant investments by sales of stock or bonds or by bank loans."

purchase of real estate from an affiliate as a "Section 790 transaction." App./Rhg., at 17-18. The adjectives most appropriate to each of these three contentions are "wrong," "absurd," and "trivial," respectively.

1. There was no inconsistency in San Gabriel's testimony regarding proceeds from real property transactions, because the two witnesses addressed very different topics.

Intervenors/DRA see inconsistency in San Gabriel's assertion that $27.5 million at issue in the staff Audit Report represented gain from real property sales while San Gabriel's accounting expert provided an exhibit showing just $4 million in property sales proceeds. Far from raising a "serious question of how various transactions are internally accounted for," Intervenors/DRA are simply mixing apples and oranges.

As was summarized in San Gabriel's opening brief, San Gabriel's President, Mr. Whitehead, responded to the staff Audit Report by providing a historical overview of San Gabriel's conduct in relation to Section 790, noting the various categories of "condemnation" actions to which the Fontana Water Company has been subjected, including sales under threat or imminence of condemnation, one formal condemnation by Caltrans, an inverse condemnation by groundwater contamination, and another inverse condemnation by service duplication. Mr. Whitehead testified that all these transactions were properly considered sales of real property, with the net proceeds (the Fontana Water Company portion of the $27.5 million to which Intervenors/DRA refer) subject to the reinvestment mandate of Section 790. Exhibit 17 (Whitehead/SGV), at 2-19.

San Gabriel's accounting expert, Mr. Snow, performed a very different analysis, reviewing San Gabriel's cash flow over a 15-year period and confirming that "the Company had more than sufficient cash flow from its operations alone to pay shareholder dividends, aggregating $51,026,400, over the period in question." Exhibit 16 (Snow/SGV), at 3-4. For

this conclusion, he relied in part on a spreadsheet he prepared that showed $189.2 million in cash from operations, $4.1 million from sale of property rights, and $35.2 million in a column titled "OTHER, NET." Exhibit 16 (Snow/SGV), Exh. A; Exhibit 66 (Snow Deposition), at 34:23-25. In deposition testimony, witness Snow explained that his "sale of property rights" column included proceeds from transactions for which the Company had made journal entries in its financial statements over the 15-year period using similar terminology , while the "OTHER, NET" column included proceeds from "various transactions over that 15-year period chiefly resulting from settlements, funds received in mitigation of chemicals and other hazards in the water and other such items." Exhibit 66 (Snow Deposition), at 35:9-38:13. Mr. Snow had no concern about whether those transactions could or should be characterized as "sales of real property" for purposes of applying Section 790. As he stated, interpretation of the application of Section 790 "was not what I was engaged to do by the firm." Exhibit 66 (Snow Deposition), at 28:1-4.

Mr. Snow testified that the Company has consistently recorded only four different types of transaction in its retained earnings accounts: Net income, "other net," and "proceeds from the sale of property rights," all as "inflows," and dividends paid as an "outgo." Exhibit 66 (Snow Deposition), at 47:15-48:11; *accord*, Exhibit 28 (Snow/SGV), at 3. The fact that San Gabriel's accounting records, as reflected in Mr. Snow's Exhibit 16, segregate contamination damage settlement proceeds "and other such items" in an "other" category separate from the proceeds of routine property sales in no way invalidates San Gabriel's rationale and legal argument (as testified to by both Mr. Whitehead and Mr. Batt) for treating some of the "other" proceeds like sales of real property for tax accounting and ratemaking purposes. *See*, Exhibit Thus, the fact that Mr. Snow listed only $4.1 million in proceeds from "sale of property rights" while Mr. Whitehead contended that a much larger amount of proceeds should be considered

within the scope of Section 790 presents no legitimate question about the consistency of San Gabriel's internal accounting practices. The two witnesses were addressing very different subjects. No inconsistency has been identified.

2. It is normal to create accounting records "after the fact" and absurd to criticize San Gabriel's accounting practice on that basis.

Intervenors/DRA criticize San Gabriel's records tracing reinvestment of "Section 790 proceeds" to particular job orders for having been "created after the fact" – during the prior GRC when record keeping issues were first raised. They see a problem in San Gabriel having accounted for these reinvestments based simply on the timing of the receipt of funds and their application to a corresponding utility plant investment thereafter. The City's witness called this "Monday-morning record keeping." App./Rhg., at 17.

This is absurd. All accounting is done "after-the-fact," and Section 790 allows eight years for reinvestment of proceeds to be completed. *See*, Exhibit 26 (Batt/SGV), at 11-12. The need for San Gabriel to develop records showing the relationship between the receipt of proceeds from property sales, condemnations, and contamination settlements and the reinvestment of those proceeds in utility plant arose for the first time in the course of San Gabriel's last GRC, so Mr. Batt, the Company's Vice President and Treasurer (as well as its chief financial officer), presented highly detailed exhibits which demonstrated that the proceeds were applied to company investments in needed utility plant, as expressly required by Section 790. *See,* Exhibit 6 (Batt/SGV), Attachments A, B, C and D; Exhibit 26 (Batt/SGV), at 8-9. These exhibits were developed from but were not part of San Gabriel's formal accounting records, which are kept, "after-the-fact," in accordance with the Commission's Uniform System of Accounts for Class A Water Utilities and other standard accounting procedures. *See,* Exhibit 26 (Batt/SGV), at 12-13; Exhibit 66 (Snow Deposition), at 40:7-16; Exhibit 28 (Snow/SGV), at

5. No deficiency has been shown in any of San Gabriel's accounting records, whether formal or informal. *See*, Decision, at 88-90.

3. The use of a standard form memo to designate transactions as subject to Section 790 does not detract from the adequacy of San Gabriel's accounting for such transactions.

Intervenors/DRA attack San Gabriel witness Nicholson's use of a "standard form memo" that labeled San Gabriel's purchase of real estate from an affiliate as a "Section 790 transaction," even though witness Batt testified that no Section 790 proceeds were used to fund affiliate transactions. App./Rhg., at 17. The purpose of including a reference to Section 790 proceeds on this form memo was for San Gabriel's officers and staff to make sure that any Section 790 proceeds available for investment in utility plant were devoted to such purposes as soon as the opportunity arose – in accordance with the mandate of Section 790(a) that the net proceeds from sale of certain real property "shall be a water corporation's primary source of capital for investment in utility infrastructure."

The form memo apparently used by Mr. Nicholson and included in Exhibit 48 (MacVey/City) was not artfully designed, since it apparently presumed the availability of Section 790 proceeds awaiting reinvestment, although such proceeds were not available at the time of the affiliate transaction. However, its purpose was the proper one of assisting in the tracking and investment of Section 790 property. *See*, Exhibit 26 (Batt/SGV), at 9, 14-15; Exhibit 29 (Whitehead/SGV), at 10-11. There is no indication that this discrepancy caused any harm. It certainly did not affect the adequacy of San Gabriel's records documenting actual receipt, expenditure, and reinvestment of Section 790 proceeds. Those records are maintained not by Mr. Nicholson, but rather by Mr. Batt, as San Gabriel's chief financial officer. *See*, Exhibit 29 (Whitehead/SGV), at 11. His records are the ones that the Decision concluded are "adequate to show the receipt of funds and the expenditure of funds." Decision, at 89; *accord,*

id. at 125 (Finding of Fact 82). Intervenors/DRA have produced no evidence that casts any doubt on the accuracy of that Finding.

V.

INTERVENORS/DRA FAIL TO JUSTIFY FORCING SAN GABRIEL TO REFUND CITY'S PAYMENTS TO SETTLE SERVICE DUPLICATION CLAIMS AND SHOW NO LEGAL ERROR IN DEFERRAL OF THIS ISSUE TO THE GAIN ON SALE CASE.

The Decision defers determination of the regulatory treatment of proceeds from condemnations, sales under threat of condemnation, and inverse condemnation by service duplication, for the reason that all these classes of transaction are within the scope of Phase 2 of the Gain on Sale rulemaking, R.04-09-003, and should be addressed in that proceeding. D.07-04-046, at 77-79, 98-99. Intervenors/DRA assert that the Commission should make an exception to its deferral of these matters for the $2.3 million in proceeds that the City paid to San Gabriel pursuant to a 1996 settlement of San Gabriel's service duplication claims against the City. App./Rhg., at 17.

As the Decision notes, all these sorts of condemnation-related proceedings are being addressed in the Gain on Sale rulemaking and there is no evident reason for making an exception for a single inverse condemnation case. It is especially odd that Intervenors/DRA would seek to highlight the equitable aspects of assigning the proceeds of the 1996 service duplication settlement, by which the City of Fontana paid compensation to San Gabriel for invading San Gabriel's certificated service area and impairing the value of the Company's public utility property and rights. Intervenors/DRA now would have the Commission require San Gabriel to "share" the proceeds of that 11-year-old service duplication settlement with its ratepayers, one of the largest of which is the City of Fontana – the very culprit responsible for inflicting service duplication damage on the utility. In effect, the City is seeking to retake part of its 11-year-old settlement, diminishing its payment obligation pursuant to that settlement.

Not surprisingly, Intervenors/DRA present the issue differently, contending without substantiation that "San Gabriel shifted the pertinent risks to ratepayers." App./Rhg., at 18. The "pertinent risks" to which Intervenors/DRA refer apparently are the risks of incurring legal expenses associated with service duplication litigation, which Intervenors/DRA perceive as being shifted to ratepayers. The fact is, the Company and its shareholders bore the entire amount of these litigation expenses, which were not recovered in rates.

Intervenors/DRA appear to be arguing that San Gabriel's estimate of outside services expense for a future test year based on a ten-year average that included some portion of the costs of pursuing the service duplication claims that resulted in the $2.3 million in proceeds at issue in this case somehow caused the ratepayers to bear those costs, which is simply not true. Contrary to Intervenors/DRA's claim, forecasting future test year expense based on a 10-year average does not shift risks to ratepayers – rather, it estimates a future test-year expense that may prove to be higher or lower than that estimate, thereby distributing that future risk between the utility and its ratepayers. The Decision's solution, which caps the allowed future test year expense based on a 10-year average[4] but requires a refund of estimated future expense that is not incurred, has the effect of imposing the risk of underestimation on the utility while protecting ratepayers from the risk of overestimating this expense. D.07-04-046, at 12-13. Interestingly, Intervenors/DRA do not challenge the legality of this method of estimating outside services expense.

Intervenors/DRA go on to claim that California's Service Duplication Law (Public Utilities Code Section 1501 *et seq*.) somehow implies that a service duplication award belongs to ratepayers, because service duplication impairs the value of utility plant that remains in rate

[4] The Commission often relies on averages of recorded expenses to estimate future test year expenses for a wide variety of expense categories.

base imposing costs on ratepayers. They claim "ratepayers take the risks – San Gabriel takes the benefits" and so call for an immediate allocation of all the benefits to ratepayers without awaiting a policy review of relevant issues in the Gain on Sale proceeding. App./Rhg. at 19.

In this argument, as in the prior briefs of DRA and the City, Intervenors/DRA make no attempt whatsoever to respond to the detailed evidence San Gabriel developed on the record of this proceeding regarding City's infliction of service duplication damages on San Gabriel, the Company's successful defense of its rights, and the Company's explanation of why the Commission should consider the proceeds of such a case as Section 790 property, subject to reinvestment in utility plant. Accordingly, San Gabriel must summarize that evidence as it relates to Intervenors/DRA's simplistic claims.

California law treats a governmental agency's duplication of the service or facilities provided by a privately owned water utility as a taking of the property of the private utility to the extent it renders the private utility's property useless, inoperative or reduces its value, and requires payment of just compensation by agreement or by court action. *See*, Exhibit 6 (Batt/SGV), at 8-9, *citing*, Public Utilities Code Section 1501 *et seq.* In past cases, even if the public agency did not physically acquire any of the utility's property, the Commission has directed the utility to account for such payments as proceeds of a sale that "should be included in Account 401 – Miscellaneous Credits to Surplus." Exhibit 6 (Batt/SGV), at 9, *citing*, *Re San Gabriel Valley Water Co.*, D.92273, dated October 8, 1980, *correcting,* D.92112, dated August 19, 1980 (hereinafter "*Montebello*").[5]

[5] These decisions were the Commission's response to *San Gabriel Valley Water Co. v. Montebello* (1978), 84 Cal.App.3d 757, which directed the City of Montebello to pay San Gabriel service duplication damages due to Montebello's extension and provision of water service in a portion of the Company's Los Angeles County division. D.92773 was provided as part of Mr. Batt's direct testimony and was further addressed in Mr. Whitehead's testimony responding to the Audit Report. *See,* Exhibit 6 (Batt/SGV), Att. E; Exhibit 17 (Whitehead/SGV), at 12-13; Exhibit 29 (Whitehead/SGV), at 14-15.

The settlement of San Gabriel's service duplication lawsuit against the City of Fontana resulting in payment of $2,314,538 in December 1996, as compensation for inverse condemnation by service duplication arising from the City's taking San Gabriel's property and rights relating to water utility service in the Hunter's Ridge area. Exhibit 6 (Batt/SGV), at 9-10 and Atts. C and C-3. Ratepayers bore none of the legal costs San Gabriel incurred to pursue its claims in that case, and no such costs were recorded in any memorandum account for future recovery. *Id.* at 10.

The staff Audit Report in this case denied that Section 790 applies to service duplication proceeds, arguing that the payment of compensation was not the result of a sale of real property. *Id.* at 23. DRA agreed. Exhibit 65 (Charvez/DRA), at 3-1. Without stating any rationale for doing so, the Audit Report included all the $2,314,538 in proceeds of San Gabriel's service duplication judgment against the City of Fontana in the total of $27,456,307 that it urged the Commission to allocate to ratepayers. Exhibit 63 (Loo/WD), at 5. So did DRA. Exhibit 65 (Charvez/DRA), at 1-1, 3-1 to 3-2.

Mr. Whitehead testified that the "service duplication proceeds" of $2.3 million resulted from a judgment entered in a Superior Court lawsuit against the City of Fontana for the City's taking of San Gabriel's property through inverse condemnation by service duplication. He explained that the case arose from the City's ultimately unsuccessful efforts to take over all of Fontana Water Company and establish a city-owned water system in the Fontana Water Company service area. That ill-fated effort, beginning in 1985, led to a Commission order dismissing as illegal the City's petition[6] seeking a valuation for condemnation of the Fontana

[6] In addition to dismissing the City of Fontana's petition for being unlawful (observing that it "founders in its own illegality"), the Commission found that the City of Fontana's attorneys had violated the Commission's Rule 1 by falsifying evidence and deliberately misleading the Commission, and then ordered these attorneys to be referred to the State Bar for disciplinary action. *Re City of Fontana* (1989), D.89-04-082, 31 CPUC2d 573, 1989 Cal. PUC Lexis 286, at *29-*46.

Water Company system. After that dismissal, the City then turned its efforts to establishing a City-owned water system in the Company's certificated service area. Under that scheme, the City required the developer of Hunter's Ridge to build water distribution facilities and turn them over for the City to own and operate, prompting San Gabriel's service duplication lawsuit that ultimately produced the $2.3 million judgment proceeds under review in this GRC. Exhibit 17 (Whitehead/SGV), at 10-11; *see also*, Tr. 726:16-727:5, 730:1-19 (Whitehead/SGV).

Mr. Whitehead explained that service duplication proceeds are treated under the California Code of Civil Procedure and under state and Federal tax laws as inverse condemnation damages and, pursuant to the Service Duplication Law (Public Utilities Code Section 1501, *et seq.*), as an involuntary sale of property. Exhibit 17 (Whitehead/SGV), at 11-12; Tr. 731:26-732:11 (Whitehead/SGV). Likewise, in the *Montebello* case noted above, the Commission expressly instructed San Gabriel to account for judgment proceeds in a service duplication case like the proceeds of a sale, even though no physical property changed hands. Exhibit 17 (Whitehead/SGV), at 13.

Mr. Whitehead further testified that the Commission, in its *Montebello* decision, not only expressly prescribed accounting treatment but also ordered water rate adjustments to give ratemaking effect to its accounting directives. Thus, the Commission already has decided both the accounting and ratemaking treatment of service duplication proceeds that San Gabriel receives – and San Gabriel has consistently followed those directives as issued in D.92273. Exhibit 29 (Whitehead/SGV), at 14. This treatment should apply whether or not service duplication proceeds are found to be within or outside the scope of Section 790. *Id.* at 15.

City witness Cuthbert alleged that, absent the City's payment of damages, ratepayers "would have eventually funded any resultant damages." On cross-examination, however, it

became clear that he could not explain how ratepayers could be at risk in a service duplication context. Exhibit 72 (Cuthbert/City), at 6, 29-31; Tr. 635:6-636:2 (Cuthbert/City).

Responding to Mr. Cuthbert's "at-risk" claim, San Gabriel witness Dell'Osa noted that service duplication damages were eliminated when, due to San Gabriel's active defense of its rights, the City of Fontana stopped serving water in San Gabriel's service area. Because the service duplication had not been anticipated in the prior general rate case (A.94-08-017 and had been resolved by the time of the next GRC (A.02-11-044), ratepayers were never affected by the City's unlawful conduct and they bore no part of the litigation expenses San Gabriel incurred to block the City's scheme. Exhibit 27 (Dell'Osa/SGV), at 10. The risks and costs all were borne by San Gabriel and its shareholders.

City witness Cuthbert's notion that ratepayers were at risk of having to pay higher rates due to the City's duplication of service, and so should be given the benefit of the City's damage payment would produce an incongruous result in view of the fact that the City is one of the Fontana Water Company's largest customers, most Fontana Water Company ratepayers are residents of the City, and it was the City's actions that caused damage to San Gabriel. It would be grossly unfair to allow the City of Fontana, as one of the Company's largest customers, to reclaim the damages the City caused to San Gabriel in the first place. *See generally*, San Gabriel Opening Brief, at 140-44. In fact, doing so would have the effect of reversing the legal remedy the Legislature sought to provide to water utilities like San Gabriel by enacting the Service Duplication Law. *See*, Public Utilities Code, Section 1501.

DRA and the City did little to refute any of the above-referenced testimony of witnesses Batt and Whitehead. Neither DRA nor the City ever has addressed the purpose of the Service Duplication Law, the Commission's *Montebello* precedent for accounting and ratemaking treatment of service duplication proceeds, or the facts of the City's failed and

unlawful past efforts to take over the Fontana Water Company. Most importantly for immediate purposes of evaluating the present application for rehearing, Intervenors/DRA have failed to establish any legal deficiency in the Decision's determination to defer to the Gain on Sale rulemaking the determination of ratemaking treatment for the proceeds of inverse condemnation claims in the service duplication context.

VI.
CONCLUSION

The City, DRA, and the School District have shown no legal error in the Decision. All they have done has been to restate arguments previously presented and rejected by the Commission. San Gabriel respectfully submits that the Commission should deny rehearing or reconsideration of any of the issues presented by the City, DRA and the School District and should make no changes in the Decision with respect to any of those issues.

Respectfully submitted,

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May 31, 2007

CERTIFICATE OF SERVICE

I, Jeannie Wong, hereby certify that on this date I will serve the foregoing RESPONSE OF SAN GABRIEL VALLEY WATER COMPANY TO CITY OF FONTANA, ET AL. APPLICATION FOR REHEARING AND RECONSIDERATION OF DECISION 07-04-046, on the parties on the service list for A.05-08-021/I.06-03-001 below.

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By hand delivery:

Hon. Robert A. Barnett
Administrative Law Judge
California Public Utilities Commission
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Executed this 31st day of May, 2007 in San Francisco, California.

/S/ JEANNIE WONG
Jeannie Wong